FINAL REPORT OF THE EPSP PENSION REFORM

TECHNICAL ASSISTANCE EFFORT

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INTRODUCTION

This report was prepared by Christopher Bender, Pension Economist, and Greg McTaggart, Pension Administration Expert. It is submitted to the U.S. Agency for International Development (USAID) as the final deliverable product of the Pension Reform Technical Assistance Effort of the Mongolia Economic Policy Support Project (EPSP).

This report contains four sections. Section I describes the objectives and provisions of the pension reform developed by the Government of Mongolia (GOM) with the support of the EPSP Pension Reform Effort. Section II summarizes what has been accomplished and what remains to be done for implementation to be completed. Section III discusses a number of policy issues that merit further attention by the GOM. Section IV makes suggestions for strengthening the State Social Insurance General Office (SSIGO).

This report also contains appendices. Appendix A lists the most important documents prepared by the EPSP Pension Reform Effort and provided to SSIGO and the GOM. Appendix B lists the members of the EPSP Pension Reform Effort. Appendix C provides recommendations for the reorganization of SSIGO. Appendix D provides recommendations for improving the collection of social insurance contributions.

This report was written in order to (a) provide a roadmap to complete the introduction of individual accounts; (b) make clear that the introduction of individual accounts represents only the first step of a two step reform; (c) offer guidance for addressing outstanding legislative, regulatory, and policy issues; (c) offer suggestions for strengthening SSIGO and improving the efficiency of its operations.

I: DESCRIPTION OF THE REFORM

The approach to pension reform taken by the GOM is outlined in a plan entitled, "Main Guidelines for Pension Reform to be Followed by the State to the Year 2021," (the Guidelines document) which was developed by the GOM with the support of the EPSP Pension Reform Effort and was approved by the Mongolian Parliament in May 1999. The Guidelines document envisages a two-step reform, involving, first, the immediate introduction of a system of individual accounts funded on a pay-as-you-go basis[1] and, second, the gradual investment of some portion of contributions into the capital markets of Mongolia and, potentially, of other countries, as well. The approach to pension reform contained in the Guidelines document has the following objectives: (a) preserving the concepts of fairness and individual equity in how workers are treated by the system; (b) protecting the needs of the elderly and persons close to retirement; (c) insuring that current workers receive reasonable pension benefits when they retire, without subjecting them to

[1] Pay-as-you-go systems – also referred to as Paygo systems – are pension systems in which current contributions are used to pay current benefits. The long term financial stability of any pay-as-you go system depends upon demographic, economic and labor market conditions.

unreasonable risks; (d) making the pension system financially stable and eliminating the dependence of the system on the general budget; and (e) introducing market-based economic reforms intended to encourage the development of the private capital markets and increase economic growth.

A. Step One: Individual Accounts

In June 1999, the first of these two reform steps became law with the passage of the "Law on Individual Pension Contribution Accounts" (law on Individual Accounts). In late 1999, and in accordance with the law on Individual Accounts, SSIGO began the task of creating and maintaining a system of individual pension accounts[2] for persons born on or after 1 January 1960. (In this report, such persons will be described as *new scheme contributors*. Persons born before this date will be described as *old scheme contributors*.) Under these individual accounts, a worker's pension will be determined by the total lifetime amount of contributions made by the worker and by employers on the worker's behalf. Initially, benefits to current and new retirees will continue to be funded entirely from contributions from current workers, as is done under the old pay-as-you-go system. Workers' contributions to the system will not be invested on their behalf during this phase of the reform. As is described below, this is an interim step designed to achieve many of the advantages of funded pension systems[3] while thoughtfully managing the cost and risk of moving to a funded system in a country with underdeveloped capital markets and a large number of older people who will not have enough working years to accumulate individual retirement funds of their own.

Individual accounts look and act like bank accounts, although no funds are actually kept in them. In this sense, individual accounts are simply an administrative record of pension contributions. Annually, the accumulated balance in a worker's account is increased by the rate of growth in average wages in the economy over the past three years. (This is done because aggregate wages determine the level of benefits that can be afforded under a pay-as-you-go pension system.) This adjustment is akin to the posting of "interest" although no funds are actually transferred. A worker's pension will be computed by dividing the worker's individual account balance at retirement by the average life expectancy for persons of the worker's age when the worker retires.

Individual accounts eliminate many of the problems of the old pension system. Individual accounts (a) enable workers to see a direct connection between the contributions they and their employers make and the pensions they receive, thereby encouraging participation in the pension system; (b) treat all workers equally and fairly and reduce hidden transfers within the pension system; (c) encourage workers to take more responsibility for their own retirement

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[2] Individual pension accounts are also called (a) *unfunded defined contribution* accounts and (b) *notional defined contribution* accounts (or NDCs).

[3] Funded systems are pension systems in which pension contributions are invested in securities. Pensions are determined by the value of those securities at the time a worker retires. Pensions are subject to investment risk. This means that the ultimate pension earned under a funded system will depend upon the performance of the investments held in the system.

planning; (d) partially protect the pension system from financial instability caused by demographic changes; (e) establish the administrative structure that can easily and transparently support the gradual transition to a partially funded system; and (f) enable the GOM to control the pace and the risks of the transition.

B. Step Two: Partial Funding[4]

The Guidelines document envisages that starting in 2005, 3% of employee wages (for new scheme contributors only) will be invested in securities so that pension benefits will ultimately be funded in part from contributions from current workers and in part from the realized value of investments when workers retire. Over time, more funding will be permitted, with the expectation that the system will be roughly half pay-as-you-go and half funded by the year 2020. The timing of this second step in the reform can, of course, be adjusted according to developments in capital markets and in the overall economy. *It will be up to the GOM to specify the path by which this transition will occur and to implement this step of the reform.*

The introduction of partial funding over the medium to long term is intended to (a) eliminate some of the labor force and demographic risks inherent in the financing of the current pay-as-you-go system and restore the financial sustainability of the system over the medium to long term; (b) be a more efficient mechanism (over the long term) for financing retirement savings and assuring that the elderly have adequate income in their retirement; (c) increase total savings in the economy and, therefore, investment, thus promoting economic development and growth; and (d) improve the efficiency of how investment capital is allocated within the economy, contribute to increased market liquidity, and improve incentives for managers to maximize investment returns to shareholders.

The decision to use individual pension accounts – funded in the short run on a pay-as-you-go basis – as a transition mechanism to a partially funded system reflects the belief that funding should be introduced gradually(over a fifteen to twenty year period) in order to (a) give time for the capital markets to mature so that invested capital can be used efficiently and can earn reasonable returns at reasonable risk; (b) create the legal and regulatory structures required to protect the integrity of the markets and the interests of pensioners in order to minimize investment risk; and (c) spread the cost of the transition.[5]

Individual accounts will facilitate this transition to a partially funded system because the administrative structure of individual accounts is identical to that of funded accounts. Under

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4 Partially funded systems are mixed systems, combining both a pay-as-you go benefit component and a funded benefit component. Partially funded systems combine the demographic and labor market risk of pay-as-you go systems with the investment risk of funded systems.

5 When moving to a partially funded system, contributions that are invested in securities under the funded component of the system are no longer available to help pay for the cost of benefits to current pensioners. Because current pensions must be paid, contributions to funded accounts create costs to the government. Such costs are commonly referred to as "transition costs."

both systems, a record is kept of individual contributions and the balance in the account is adjusted each year. In the case of individual accounts, the adjustment is entirely administrative and is based on the growth of average wages in the economy. In the case of funded accounts, the adjustment is made to reflect the actual earnings generated by the investments held in a worker's account. At retirement, both systems use the account balance to determine a worker's pension, based on the age the worker retires and the average life expectancy for persons of that age in Mongolia. Individual accounts will easily accommodate the transition to partial funding because some portion of the contributions made to the pension system can be credited to a worker's individual account and will earn an administrative rate of interest based on the rate of growth in average wages, and some portion can actually be invested and will earn whatever rate of return is generated by the securities held by the account.

The pension reform is consistent with a commitment to private sector led growth and market-based economic reforms. The introduction of partial funding is intended to contribute to the development of the capital markets (by providing a source of funds for investment) while, at the same time, giving current workers the opportunity to share in the gains from this development in the form of higher benefits when they retire. For the reform to succeed, the capital markets must be capable of using invested capital efficiently and generating reasonable returns at reasonable risk. The success of the reform also depends on the eventual emergence of products and services to support the markets. Examples of such products and services include investment management, trusteeship, brokerage, and financial instruments such as guaranteed investment contracts and other mechanisms for turning funded accounts into monthly benefits for pensioners. *The EPSP Pension Reform Effort strongly encourages the GOM take steps to encourage the emergence of such products and services.*

II: IMPLEMENTATION OF INDIVIDUAL ACCOUNTS

The pension reform was passed into law by the Mongolian Parliament in the Spring of 1999, with an operative date of 1 January 2000. Implementing a reform of this magnitude would have represented a major challenge for any social insurance organization in any country under even the most optimal of circumstances. In Mongolia, however, circumstances are far from optimal and have made the administration of the pension system more difficult (and more costly when administrative costs are expressed as a percentage of contributions) than it would be in most other countries of the world.

<u>The current economic climate</u> limits the capacity of employers to pay social insurance contributions and other social insurance levies. Payments of contributions are often in arrears and public sector employers, including state-owned or state-controlled enterprises, are among the worst offenders. (Roughly 60% to 70% of the outstanding debt owed to SSIGO is owed by the public sector.) This not only limits the funds available to SSIGO to make benefit payments on a timely basis, but it also (a) makes it difficult for SSIGO to effectively forecast its own cash flows; (b) encourages non-compliance by private sector employers; and (c) limits the capacity of the organization to implement changes.

<u>Mongolia's highly dispersed population and low population density</u> require SSIGO to maintain local offices in soums which have relatively few contributors and beneficiaries.

This increases staffing ratios (and therefore costs) relative to countries with less physical area and higher population densities. The demanding physical environment found in Mongolia also increases transportation costs and maintenance costs for computer and office equipment.

The absence of reliable telecommunications infrastructure and the absence of reliable access to electricity requires SSIGO to transport some electronic data in the form of physical media (floppy discs and Zip disks), rather than send the data via a dial-up connection to SSIGO's IT Center. It also limits SSIGO's ability to field computers in many of its offices. Moreover, interrupted power can cause data loss and corruption and make computers unavailable for use. The inadequacy of Mongolia's existing infrastructure affects costs directly (for example, by adding to transportation costs) and indirectly (for example, by limiting office automation or increasing the staff time spent overcoming these limitations).

The budget available for SSIGO to administer the system is highly limited. Currently, SSIGO's administrative costs are capped at 2% of the amount of contributions it collects. This would be an appropriate ceiling in countries without such demanding circumstances and which have already invested substantially in computer technology and office automation. In Mongolia, this ceiling is too low for SSIGO to effectively administer the program, much less make the sorts of improvements that are needed to support the pension reform.

In addition to these challenges, the timeline established for the implementation of the reform was highly aggressive by international comparison. Against these odds, however, SSIGO has done an admirable job, and implementation of the reform has been substantially completed.

A. What Has Been Accomplished

Even if SSIGO had been given more time to implement the reform, implementation would have still represented a major challenge. In order to implement the reform SSIGO has had to:

- train all of its staff on the provisions of the reform and the implications for SSIGO for the administration of the reformed system;
- compile historical monthly contribution data and service history data for persons covered by the reform (new scheme contributors) from wage history books, social insurance books, and other paper documents;
- enter the data from these documents into newly created computer databases;
- write computer programs to compile and manipulate this data in order to calculate opening balances for new scheme contributors (the purpose of which is to recognize the contributions of such persons made before the passage of the reform);
- implement new procedures for the shipping of paper records from non-computerized soum offices to SSIGO's Aimag and district offices and for the entry of this data into computers; and

- modify the software it uses to administer the pension system to accommodate the changes required by the reform and to improve the functionality provided by the software.

Changes to the software were necessary so that, in the future, SSIGO can (a) organize and report contribution data by individual contributor; (b) accrue and post interest on a contributor's opening balance and any contributions made during the year,(c) deduct from contributions a charge for the cost of administration and social transfers; and (d) create contributor statements on an annual (or more frequent) basis. Moreover, because the reformed system cannot be practically administered without the use of computers (whereas the old system could), the reform will also require SSIGO to modify how it handles and stores computerized data to protect against data loss and unauthorized tampering or manipulation. This will have substantial implications for how SSIGO operates and, consequently, for its staffing structure and administrative procedures.

B. Implementation Is Substantially Completed

Despite (a) the difficulties created by the circumstances of administering social insurance in Mongolia; (b) the challenges demanded of SSIGO in implementing the reform; (c) the aggressive timeline established by the Mongolian Parliament for the implementation of the reform; and (d) the limits imposed on SSIGO by the 2% ceiling on administrative costs, SSIGO has done an admirable job of implementing the reform. It has certainly performed as good as – if not better than – other social insurance organizations in the former Soviet Union that have been tasked with implementing a reform of such magnitude. *This performance is, in large measure, a reflection of the (remarkable) dedication of SSIGO's staff to making implementation a success*. SSIGO's staff should be credited for working long hours, often without compensation, on wages that are already low by comparison to other organizations in Mongolia.

Implementation of the reform has been substantially completed. A number of tasks remain unfinished – but none are critical at this point in time – and SSIGO has a clear understanding of what is required of it. There is no reason to believe that SSIGO will not be successful in completing these tasks by the time they become critical to the administration of the reformed program. *With respect to the issuance of contributor statements, which represents the most important benchmark for measuring implementation success, SSIGO now has the capacity to create and distribute contributor statements to all program contributors.* The actual issuance of these statements cannot be done until SSIGO has gotten the necessary guidance from the Social Insurance National Council (SINC) on several key policy issues, but there is no reason that statements cannot be produced once the SINC has passed judgment on these issues.

C. What Remains To Be Done

As stated above, the issuance of contributor statements is the primary benchmark adopted by the EPSP Pension Reform Effort for evaluating SSIGO's progress in implementing the reform. The sole remaining impediment to the issuance of contributor statements is the resolution of a number of outstanding policy issues that require decisions by the SINC. Once these policy issues have been addressed by the SINC, SSIGO will need to make minor modifications to the computer software it has developed to create contributor statements before the statements can actually be issued. The policy issues that must be addressed by the SINC are discussed briefly below and are explained fully in the documents referenced in Appendix A.

1. Operational and Computer Capacities

The issuance of contributor statements, however, does not mean that no further activity is required on the part of SSIGO to administer the reformed program. Individual accounts must still be established for those unemployed persons who do not yet have them. (The issuance of statements should encourage such persons to report to their local SSIGO office with the necessary documentation.) Moreover, the administration of the reformed program will require SSIGO to fully implement and manage the operational procedures it adopted over the past year in support of the reform. The most important of these procedures relate to the need to:

- physically transport paper records from non-computerized soum offices to SSIGO's Aimag offices on a regular basis;
- enter data from paper records from non-computerized soum offices into computers on a timely basis;
- create a national database of contributor and employer data that can be used by SSIGO's Headquarters staff to manage the overall system of social insurance;
- safeguard computer data to protect against data loss, data corruption, and unauthorized tampering or manipulation.

Moreover, administration of the reformed program will require SSIGO to tackle new tasks in the future which did not have to be addressed in order for it to issue contributor statements. Tackling these issues will take time. Some of the tasks which still lie before SSIGO include:

- modifying the software to compute benefit entitlements under the reform, including algorithms to address issues such as the minimum pension and entitlements for survivors and disabled persons;
- creating the capacity to provide entitlement and account information on demand for contributors and for employers in Aimag and district offices, as well as in non-computerized soum offices;
- developing the capacity to develop actuarial projections of future cash flows in order to provide information to policy makers tasked with specifying the transition to partial funding.

For some of these tasks, SSIGO will need the support of the SINC (for example, the SINC must approve the procedures by which benefits are computed, including life expectancy factors for use in translating a contributor's final account balance into a pension amount).

2. Crediting Interest to Individual Accounts

Procedures must be established for crediting interest to individual accounts. At the root of this issue is the question of whether interest on monthly contributions should start to accrue (a) when the wages are paid to employees (and the employee portion of social insurance contributions is deducted from gross wages); or (b) when the contributions are actually received by SSIGO. *The EPSP Pension Reform Effort recommends that interest start to accrue when wages are paid to employees*. In practice, this means that employees will not be penalized for the actions of their employers when their employers do not pay contributions on time. This option is fair to employees and is consistent with the law. (It is also the only practical approach, given the current structure of SSIGO's accounting procedures.) The EPSP Pension Reform Effort discussed this issue more fully in a memorandum entitled, "Procedures for the Computation of Interest," dated 11 September 2000.

3. Deductions for Administrative Costs and Social Transfers

The deduction for the cost of administration and social insurance must be clarified. The Guidelines document states that, "4% of the total income of the pension fund shall be credited to a special account to pay for the costs of administration and to pay for the costs of the minimum pension, benefits for survivors and disabled persons". There are two problems with this provision:

- the 4% charge ought to be assessed against wages, rather than contributions (four percent of contributions is far too low by international standards); and

- there is no need to create a special fund for these monies.

The purpose of the deduction is to reduce the amount of contributions credited to individual accounts (from 19% of wages to 15% of wages) in order to recognize the fact that a portion of contributions (4% of wages) must be used to pay for administrative costs and the costs of transfers for social purposes. The actual flow of funds within the program is an entirely separate issue: these funds will, in actual fact, always be used to pay for the cost of benefits to current beneficiaries and for current administrative expenses. They will never accumulate and, thus, no special fund is needed for them. *The Parliament should pass legislation to clarify this issue and should make the changes effective retroactively to 1 January 2000. Contributor statements cannot be issued until this issue is clarified*.

4. Benefits in the Case of Partial Disability

Benefit provisions for partially disabled persons must be clarified. In most countries, the benefits provided to persons who are disabled are proportional to the level of disablement (under the assumptions that (a) modestly disabled persons will be able to secure jobs paying more than the jobs paid to more severely disabled persons; and (b) fully disabled persons will be completely unable to work). The wording of Article 8.3 of the law on Individual Accounts implies that partially disabled persons, in some cases, will be eligible for higher benefits than some fully disabled persons. The Parliament should pass legislation to correct this anomaly.

5. Ceilings on Contributions

The application of wage ceilings for very highly paid employees when crediting contributions for individual accounts must be clarified. The employee share of contributions for very highly paid employees is limited to 5.5% of the maximum salary for contribution purposes. The maximum salary for contribution purposes is defined as ten times the minimum wage. The employer share of contributions for such employees, however, has no ceiling and is always 13.5% of actual salary (for public sector employees different contribution rates may apply). [Note that in the long run, the provisions of the Guidelines document should be enacted into law, which means that the contribution ceiling will be changed to three times average wages and will apply to both the employee and the employer share of contributions.] The existence of a ceiling on wages for contribution purposes raises the question of whether or not the ceiling should be applied for the purpose of crediting contributions to the individual accounts of new scheme contributors. Given that the wage ceiling is applied to the benefits of old scheme contributors – that is to say, the annual salaries used to compute benefits at retirement are limited to ten times the minimum wage for very highly paid employees – *the EPSP Pension Reform Effort recommends that the ceiling be applied to both the contributions of employees and the contributions of employers* when crediting contributions to the individual accounts of persons covered by the reform. The EPSP Pension Reform Effort discussed this issue more fully in a memorandum entitled, "Comments on Software for Contributor Statements," dated 13 September 2000.

6. Resolution on Working Pensioners

The provisions governing working pensioners should be revised. Currently, when a pensioner returns to work, he or she (a) is no longer eligible to receive a benefit payment; (b) is required to recommence making contributions, just like any other employee; but (c) is not awarded additional service credit or contribution credit. When the contributor again ceases to work, he or she will get the same pension as before with adjustments only for inflation. *The EPSP Pension Reform Effort believes that this is unfair.* Pensioners who return to work should be given additional credit for the additional contributions they make. (For simplicity, the GOM might consider imposing the requirement that additional credit be given only in cases where a pensioner returns to work for a minimum of one year.) As an alternative, the GOM might simply remove all persons over the retirement age from participation in the system. Such persons could be permitted to draw a pension whether they are working or not. Those pensioners who choose to continue to work would no longer have to pay additional contributions – nor would they receive additional benefit rights. There are three compelling reasons for this approach: (a) it is administratively simple; (b) it is almost impossible to enforce a standard that prohibits pensioners from working while drawing a pension; and (c) the rule is easy to explain and understand.

7. Contributor Statements for Civil Servants

The format for contributor statements issued to civil servants (i.e., persons working for governmental ministries, agencies, government offices, fire and police departments, etc.) should be reviewed. For such persons, the share of the total 19% contribution rate paid by employees and the share paid by employers is different from the relative shares found outside the public sector (where employees pay 5.5% and employers pay 13.5% of gross wages). Those shares vary from organization to organization. To prevent confusion, the statements prepared for such contributors should simply show the contributions paid *in total* without showing a breakdown of what is paid by employees and what is paid by employers.

8. Public Education Issues

Informal feedback gathered by the EPSP Pension Reform Effort suggests that future public education efforts by SSIGO should be careful to clarify that (a) *individual accounts are not bank accounts* (i.e., individual accounts are only an administrative accounting of contributions and thus no funds are kept in them); (b) *the balance in an individual's account is not transferable upon the death of a contributor* (instead, the dependents of such a person may be eligible for a survivor's pension) *or upon the death of a pensioner* (instead, a funeral benefit is paid).

III: OUTSTANDING ISSUES

A. Specifying the Transition

The GOM should place the introduction of partial funding high on its list of priorities, given the (relatively long) lead time required to implement this phase of the pension reform. The transition to partial funding requires the creation of strong legal and regulatory institutions, clear and comprehensive laws, and detailed regulatory and enforcement guidelines in order to support the successful introduction and operation of private pension funds. It also requires the resolution of a number of issues pertaining to how such a system will be administered and the role SSIGO will be expected to play. The EPSP Pension Reform Effort recommends the following schedule: (a) in 2000-2001, focus on making individual accounts function effectively, developing public understanding of the system, and building public support for the reform; (b) during the period 2002-2003, establish the legal and regulatory structure for voluntary private pensions; (c) once the legal and regulatory structures are in place, during the period 2003-2004, encourage the introduction of voluntary private pensions (voluntary private pensions are a good way to "test the waters" of the system without putting people at risk without their explicit consent); (d) in 2004, require the additional costs of privileged pensions (for workers in hazardous conditions, mothers with multiple children, etc.) to be fully funded by employers; funds should be invested in a Government bond fund resident at SSIGO; this will also test the administrative capacity of SSIGO to manage the flow of funds under partial funding; contract the management of the money to two or more private money managers, so that SSIGO is not a player in the Government securities market; (e) in 2005, begin the introduction of partial funding by diverting 2% of insurable wages to the Government bond fund; (f) in 2006 or 2007, begin to ease investment restrictions, permitting investment of assets first outside of Mongolia (in established international bond and equity markets) and later inside Mongolia (in corporate bonds and equities); (g) each year thereafter, gradually increase the percentage being diverted into the funded portion of the system; (h) pace the transition based on the experience gained on the capacity of the capital markets to absorb the funds and the ability of the Government to finance the transition without additional borrowing (or at least without large amounts of borrowing). The ultimate schedule might look something like the following (although *the EPSP Pension Reform Effort does not recommend codifying this into law* given that one of the guiding principles of the reform is that the Government should have control over the transition):

Year	***Percentage to Funded Accounts***
2000	0.0%
2005	2.0%
2010	4.0%
2015	6.0%
2020	7.5%.

After 15-20 years, the system will be 50% funded, with 7.5 % of insurable wages (i.e., the share paid by employees under the Guidelines document[6]) invested through the funded pillar and 7.5% of insurable wages (i.e., the share paid by employers, net of deductions, under the Guidelines document) being used on a pay-as-you-go basis to pay for benefits to current pensioners.

B. Covering the Self Employed

Under the law on social insurance, cattle breeders and the self-employed – collectively referred to in this report as self-employed persons – may choose whether to be covered by social insurance and in which social insurance programs to participate.[7] At issue is the question of whether self-employed persons should be compelled to participate in the pension program. *The EPSP Pension Reform Effort strongly recommends against making participation of self-employed persons mandatory*, given that (a) experience in other countries has shown that contribution payment compliance by self-employed persons is always extremely low; (b) mandating coverage in the face of high rates of evasion erodes the program's credibility; (c) the high administrative costs of collecting from this segment of

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6 Under the Guidelines document, the rate paid by employees for social insurance will rise to 7.5% of wages and the rate paid by employers will fall to 11.5% of wages. The EPSP Pension Reform Effort supports this change, provided that it is accompanied by an increase in gross wages such that employees receive the same net pay (i.e., gross wages less deductions) and employers pay the same wage bill (i.e., gross wages plus social insurance contributions). The EPSP Pension Reform Effort discussed this issue more fully in a memorandum entitled, "Implementing the Change in the Contribution Rate," 12 February, 1999.

7 Herdsmen who are employed by an economic unit or organization are not considered to be self-employed for the purpose of social insurance.

society will offset a substantial portion of the contributions collected; (d) many such persons will be eligible only for the minimum pension, the cost of which will exceed (on a lifetime basis) the total amount of contributions made during the working years (this is certain to be the case for the vast majority of old scheme contributors); (e) it will result in large monetary transfers within the pension program from persons working in the formal economy to the self-employed; (f) it will increase incentives for workers to migrate to the informal economy and such incentives should always be minimized; (g) herders may require lower monetary income in old age than other groups, but it will be both complicated and politically difficult to provide for two types of minimum pension benefits within the reformed program; (h) in order to achieve the goal of financial viability over the medium to long term, it will necessitate raising the contribution rate, increasing the transfer from the general budget to the pension program, or reducing the 15% contribution credited to individual accounts; and (i) the social assistance program is probably a more efficient vehicle for targeting poverty among this group in old age. The EPSP Pension Reform Effort discussed this issue more fully in a memorandum entitled, "Mandating the Participation of the Self Employed in Social Insurance," dated 28 August 2000.

If participation by the self-employed is made mandatory – again, *something that the EPSP Pension Reform Effort strongly recommends against doing* – then; (a) self-employed persons should be permitted to contribute to social insurance whenever they can and should be given flexibility with regard to how much they are expected to pay; (b) service credit (toward the minimum pension) should only be awarded when a self-employed person's contributions exceed a minimum contribution amount equal to at least 19% of the minimum wage; and (c) the minimum requirement for receiving a pension should be changed from 15 years to 180 months to give self-employed persons greater flexibility in making contributions.

C. Equalizing Benefits

The Guidelines document states that, "the guiding principle will be to ensure equilibrium in the amount of pensions paid from individual accounts and that provided under the old system. In this respect, the relevant laws will be amended." The EPSP Pension Reform Effort supports this objective, but the GOM should recognize that it will be very difficult (both practically and politically) to accomplish. Given the complexity of the issue, the EPSP Pension Reform Effort strongly recommends that benefit equalization be accomplished through the application of a *simple approach* which (a) is applied only once to everyone at exactly the same time (i.e., it should not become a yearly event, which would only serve to undermine the purpose of the reform); (b) considers only the *average pension* as the benchmark for benefit parity (i.e., the purpose of benefit equalization is to make the system fair for the average person retiring under the reform – not to restore the old benefit formula for persons covered by the reform); and (c) is structured so that *benefit parity is accomplished at the margin* (i.e., such that the average pension for persons born just before and just after 1 January 1960 is roughly comparable).

Over the long term, average benefits expressed in terms of replacement rates (i.e., as a percentage of final year's wages) must fall slightly if the pension system is to become financially self-sufficient. The pension reform accomplishes this without (a) putting the poor at risk (by providing a minimum pension which is comparable to that provided under the old law); or (b) eroding the social safety net (benefits are still awarded to disabled persons and to survivors). Benefits *should* be reduced for certain groups within the population, however, including persons who experience long periods of unemployment, who only work intermittently, or who retire early. This is not only appropriate (these persons do not contribute enough to justify the benefits they get under the old pension law), it is necessary for the pension system to become financially viable. What is important, however, is that benefit reductions be introduced gradually, so that persons at the margin (i.e., persons born just before and just after 1 January 1960) do not see a substantial drop in the amount of their pension. A precipitous drop in pensions from one birth year to the next would be unfair.

In order to accomplish benefit parity, three options should be considered. First, the GOM could attempt to modify the current benefit formula so that average pensions are slowly reduced. This will be politically and administratively difficult to accomplish, although it will help to restore financial stability to the program. Second, the GOM could wait until new scheme contributors begin to retire and multiply the account balances of all new scheme contributors by the same factor. This will accomplish benefit parity at the margin, while still providing for a gradual reduction in benefits for successive generations of persons who retire after the adjustment has been made. Third, the GOM could take steps now to adjust the *opening balances* for all new scheme contributors by multiplying those balances by a factor designed to provide benefit parity when the first of those new scheme contributors begins to retire in the future. (Based on analysis conducted by the EPSP Pension Reform Effort, the amount of that factor should be approximately 2.0.) *The EPSP Pension Reform Effort recommends the third approach*, as it is likely to be easiest to implement and less politically contentious when the first generation of new scheme contributors begins to retire in ten or so years.

D. Equalizing the Retirement Age

Article 1.1 of the Guidelines document states that retirement age for women should be raised so that the retirement age for both women and men is age 60. (By retirement age it is meant the age at which persons are *first eligible* to receive a benefit under the pension program.) The EPSP Pension Reform Effort applauds this politically difficult, but highly necessary step. Absent this step, the pension fund will never become financially self-sufficient. The importance of raising retirement ages is a lesson being learned all over the world, including most of the countries of the former Soviet Union.

Experience elsewhere suggests that many workers will choose to retire at the earliest possible age, independent of whether the overall level of their pension is high enough to sustain them in retirement. The current retirement age in Mongolia for women is too low, given existing life expectancies for women who are now aged 55. (Moreover, life expectancies for women already greatly exceed those for men, so there is no actuarial justification for permitting women to retire five years earlier then men.) Maintaining current retirement ages for women will result in (a) benefits that are too low from a perspective of social adequacy, and, therefore; (b) large numbers of women potentially becoming entitled to the minimum pension. This undermines the incentives of the reform and breaks the link between contributions and benefits.

The EPSP Pension Reform Effort strongly encourages the GOM to implement this provision of the Guidelines document which has not yet been incorporated into the law on Individual

Accounts. Equalization of the retirement ages for men and women should be done gradually, however, for reasons of political acceptability and fairness. *The EPSP Pension Reform Effort recommends that the retirement age for women be increased to age 60 at the rate of six months per year for a period of ten years.*

The EPSP Pension Reform Effort also recommends that the retirement age for men and women be gradually raised further to age 65, once the ages for men and women have been equalized at age 60.

E. Addressing Privileged Pensions

Although Mongolia's pension system does not offer special benefits to nearly as many privileged groups as do the pension systems of many countries, there are still four groups which benefit from special treatment. These include (a) women with four or more children and twenty years of service credit (who can retire at 50); (b) men with twenty years of service credit who have worked under ground for ten years (who can retire at 50); (c) men with twenty years of service credit who have worked in hot conditions for ten years (who can retire at 50); and (d) women with twenty years of service credit who have worked in hot conditions for seven and a half years (who can retire at 45).

Pro-natal policies are not common outside Mongolia. The existence of such policies, *while not advisable from the perspective of fiscal stability*, reflects social and political values that fall beyond the scope of this report. The GOM should be aware, however, that one of the implications of the pension reform is that women who were born after 1 January 1960 and who retire under this provision of the law will receive a very low pension from their individual account because (a) they will have contributed for fewer years than persons who retire at the minimum retirement age (so their account balance will be low); and (b) their life expectancy at retirement will be very high (so the pension factor applied to their closing account balance will be large). The GOM must decide if these women will be eligible for the minimum pension, despite retiring before the minimum retirement age.

Special benefits paid by the government for persons working in hazardous conditions, however, are not justified. Persons working in hazardous conditions retire early and live for fewer years after retirement. Despite this, the overall cost of their pension, relative to the amount of their contributions, is typically higher because they accumulate fewer years of service credit. In more developed countries, discrepancies in life expectancy have fallen substantially as a result of improved safety standards and actions taken by employers to reduce health risks for their employees in order to attract and retain workers in these industries. The best way to force employers to take such steps is to require them to pay for the higher costs of providing special benefits for their workers in retirement. Employers (not the GOM, unless it is acting as an "employer") should be required to pay these costs.

The GOM should be aware that most new scheme contributors working in hazardous conditions will receive a very low pension from their individual account because (a) they will have contributed for fewer years than persons who retire at the minimum retirement age (so their account balance will be low); and (b) their life expectancy at retirement will be very high (so the pension factor applied to their closing account balance will be large). If it is desirable for persons working in hazardous conditions to get a higher pension than is provided under the new pension system, then the GOM should either (a) make such persons eligible for the minimum pension (despite their retiring before the minimum retirement age) and require employers to pay more than the statutory 19% contribution rate in compensation to SSIGO for the additional cost of providing the minimum pension to such persons; or (b) require employers to make contributions to private pension funds in order increase the total benefits received by their employees at retirement.

F. Indexing Pensions

Article 10.1 of the law on Individual Accounts states that pensions shall be adjusted by an index determined in direct relation to inflation. The EPSP Pension Reform Effort strongly supports this provision. In the long run, automatic benefit indexation is crucial to the fiscal sustainability (and manageability) of the social insurance fund and is vastly preferable to the ad hoc adjustments now being made. From the perspective of social policy, it is far better for retirees to receive lower but predictable benefits (which are automatically indexed for inflation) than to receive initially high benefits which are constantly eroded in the marketplace by inflation and then partially restored through ad hoc increases. Eventually, once the fiscal condition of the pension fund improves, old age pensions, disability benefits, benefits for survivors and other social insurance benefits under both the old pension law and the reformed system *should all be adjusted automatically and regularly* for increases in prices, rather than adjusted on an ad hoc basis, as is the case now. Ad hoc indexation is not desirable, as it tends to result in inter-generational inequity and makes indexation a political issue, instead of an economic one. Price indexation – rather than wage indexation – is appropriate, in the case of Mongolia, given the fiscal constraints surrounding the pension fund.

G. Improving Health Insurance

While the health insurance program falls outside the domain of the EPSP Pension Reform Effort, the GOM should evaluate the premium structure of the program. The health insurance program effectively functions as a transfer program from the formal to the informal sector. Herders and the self-employed pay only a fraction of the effective cost of health insurance and the near universal rates of enrollment are strong indicia that people are enrolling in the program to pay for immediate healthcare costs, rather than enrolling in the program to insure against future healthcare needs. Providing universal, publicly subsidized healthcare is a reasonable policy suggestion, of course, but the program is now not functioning as the insurance program it was designed to be. At the very least, some consideration should be given to the implicit transfers in the program and to adjusting the premiums paid under the program.

IV: STRENGTHENING SSIGO

A. Increasing the Budget

SSIGO desperately needs additional funding (beyond the ceiling of 2% of contributions currently provided) in order to (a) increase salaries to competitive levels, reduce turnover and absenteeism, and improve service quality (of particular concern is the fact that salaries paid to SSIGO staff, especially to SSIGO's most senior staff, are very low by comparison to the private sector); and (b) invest in computers and computer automation. Given how little automation has thus far been introduced into SSIGO's operations, opportunities exist to dramatically increase efficiency and, eventually, to reduce staffing levels. If the organization is given the resources it now needs to make these investments, the eventual result will be reduced administration costs, probably to a level that is lower (expressed as a percentage of contributions) than it is today. Moreover, increasing the budget through a negotiated process, as suggested below, will help to insure that additional funds are well spent.

B. Rationalizing the Budgeting Process

The process by which SSIGO's administrative budget is established should be changed from an arbitrary 2% of contributions to an annually negotiated process by which SSIGO (a) submits a budget based on its assessment of the funds it needs to effectively administer social insurance; and (b) is required to justify that budget based on a five-year organizational development plan. The GOM can then assess the relative merits of different parts of that development plan and can arrive, in cooperation with SSIGO, at a budget that is better suited to what SSIGO actually needs and which reflects the GOM's priorities.

C. Developing an Organizational Plan

The EPSP Pension Reform Effort strongly recommends that SSIGO be tasked with developing a five-year development plan which can be used as the basis for negotiations over SSIGO's annual budget. Recommendations for strengthening SSIGO are contained in Appendix C.

D. Developing an Information Technology Plan

SSIGO's five-year development plan should pay close attention to the issue of information technology. The EPSP Pension Reform Effort's recommendations on this topic are contained in a document entitled, "Final Report on IT Issues in Support of the Pension Reform," by Jonathan Tomar, dated 21 June 2000. In this document, the EPSP Pension Reform Effort recommends, among other things, that (a) the GOM should provide additional funds to enable SSIGO to invest in computers and computer automation and to upgrade existing computers and computer equipment as that equipment becomes obsolete; (b) SSIGO should develop a Management Information System (MIS) for use in improving the management of the program; (c) SSIGO should investigate ways of automating its operations, including especially the use of optical scanning or bar code readers for entering contribution data and the expanded use of electronic filing; (d) the IT Center should continue to expand the use of electronic data transmission between SSIGO's Headquarters and its Aimag, district, and soum offices; and (e) the IT Center should investigate opportunities for (a) integrating Internet technologies into SSIGO's operations; (b) migrating its software, databases, and networks toward more modern operating environments; and (c) taking advantage of developments with regard to client-server architecture.

E. Improving Tax Collection

The financial condition of the social insurance system depends critically on the effectiveness of SSIGO in collecting social insurance contributions. The EPSP Pension Reform Effort's recommendations on this topic are contained in a document entitled, "Improving the Collection of Social Insurance Contributions in Mongolia," by Chris Murray, dated 27 January 2000, which covers topics such as (a) procedures for the registration of employers and self-employed persons; (b) the processing of contribution forms and payments; (c) primary control systems; (d) debt collection; (e) auditing; and (f) improved cooperation with the State Tax Authority. A summary of the recommendations of this report is contained in Appendix D.

In addition, questions regarding the relationship between SSIGO and the State Tax Authority should be resolved. Discussion over the proper roles and responsibilities of each of these organizations and how they should interact is appropriate. However, persistent rumors – in particular, rumors regarding the transfer of responsibility for collecting social insurance contributions from SSIGO to the State Tax Authority – are detrimental to the morale of both organizations. These issues should be evaluated and resolved as soon as possible. There are arguments both for and against the transfer of responsibility for the collection of social insurance contributions to the State Tax Authority, and the EPSP Pension Reform Effort does not hold an opinion on the best approach. (The EPSP Pension Reform Effort does, however, recommend against suggestions to separate the administration of social insurance from the administration of health insurance for reasons of efficiency.) If the State Tax Authority assumes responsibility for collecting social insurance contributions, it should also assume responsibility for pursuing delinquent contributors – i.e., it should handle both collection administration, as well as enforcement.

F. Addressing the Problem of Arrears

The collection of past debts from budgetary organizations (that is, organizations funded by the general budget, including government offices) for social insurance is essentially no different than a budgetary transfer. For debts that are more than six months old, it would be administratively easier for the GOM to permit SSIGO to forgive these debts and avoid the time-consuming, costly, and practically non-productive process of pursuing them. Debt forgiveness for budgetary organizations should not, under any circumstances, be extended to state-owned or state-controlled enterprises, of course, for obvious reasons. It might also make sense to eliminate cash transfers from budgetary organizations to SSIGO and to account for social insurance costs through journal entries reconciled through general budgeting accounts. (The funds awarded to such organizations would need to be reduced accordingly.)

APPENDICES

APPENDIX A: REPORTS AND MEMORANDA

APPENDIX B: MEMBERS OF THE EPSP PENSION REFORM EFFORT

APPENDIX C: ORGANIZATIONAL DEVELOPMENT PLAN

APPENDIX D: IMPROVING CONTRIBUTION COLLECTIONS

APPENDIX A: INVENTORY OF REPORTS AND MEMORANDA

Recommendations for Pension Reform in Mongolia

Pension Reform in Mongolia: Issues & Recommendations, by Christopher Bender, 25 June, 1997

Pension Reform in Mongolia: a Final Report, by Christopher Bender, 25 June, 1997

Policy Issues for the Introduction of Individual Accounts in Mongolia: Analysis and Recommendations, (a draft report for discussion only), by the EPSP Pension Reform Effort, 29 March 1998

Proposed Specifications of the New Pension System, by Christopher Bender and David Lindeman, 24 April, 1988

Arguments Against Full Funding in Mongolia, by Christopher Bender, 24 April 1998

Pension Reform in Mongolia: Economic, Financial, and Actuarial Justifications, by Christopher Bender, 10 June,1998

Transition Specifications, (a memorandum on the transition to partial funding), by Christopher Bender, 25 May, 1998 (updated 26 January 2000)

Reports by Members of the EPSP Pension Reform Effort

Reform of Social Insurance / Initial Report on Administration Issues, by Greg McTaggart, 23 March 1998

Report on Information Technology Issues, by Jonathan Tomar, 30 March 1998

Report on Demographic Trends in Mongolia, by Willem Schuddeboom, 31 March 1998

Actuarial Report on the Mongolian Pension System, by Willem Schuddeboom, 5 June 1998

Improving the Collection of Social Insurance Contributions in Mongolia, by Chris Murray, 27 January 2000

Final Report on IT Issues in Support of the Pension Reform, by Jonathan Tomar, 21 June 2000

Analysis and Recommendations on Issues of Policy

Implementing the Change in the Contribution Rate, by Christopher Bender and Greg McTaggart, 12 February, 1999

Mandating the Participation of the Self Employed in Social Insurance, by Christopher Bender and Greg McTaggart, 28 August 2000.

Procedures for the Computation of Interest, by Christopher Bender and Greg McTaggart, 11 September 2000

Analysis and Recommendations on Issues of Implementation

Initial Account Balances, by Christopher Bender and Greg McTaggart, 15 February 1999

Pension Reform Implementation Schedule and Calendar, by Christopher Bender and Greg McTaggart, 16 February 1999

Contribution Collections, by Christopher Bender and Greg McTaggart, 12 June 2000

Contributors Who Change Employers, by Christopher Bender and Greg McTaggart, 6 July 2000

A Checklist for Contributor Certificates, by Christopher Bender and Greg McTaggart, 21 August 2000

Comments on the Software for Contributor Statements, by Christopher Bender and Greg McTaggart, 13 September 2000

Public Education Materials and Public Education Plan

5-Part Description of The Pension Reform, by Viktoria Olskaia, 12 October 1998

Twenty Questions on Pension Reform in Mongolia, by Viktoria Olskaia, 25 June 1998 (Handout for the Mongolian Parliament and Mass Media)

Communication Strategy in Support of Pension Reform in Mongolia, by Viktoria Olskaia, June 1998 (updated 25 October 1998)

Manuals and Training Materials

Training Plan for SSIGO Staff for the Implementation of the Pension Reform, Training Period: January-April 1999, by the EPSP Pension Reform Effort, 6 November 1998

Pension Reform in Mongolia: a Procedure Manual for Employers, by the EPSP Pension Reform Effort, 9 November 1998

Pension Reform in Mongolia: a Training Manual for SSIGO Staff, by the EPSP Pension Reform Effort, 17 November 1998

Background Documents and Other Materials

Report on the Creation of a Funded System for Mongolia, by Rhoda Davis, 27 May 1997

Individual Accounts: a Briefing Paper for the Government of Mongolia, by Christopher Bender, 18 June,1997

Pension Reform: Managing the Transition, (a presentation to the Working Group of the Standing Committee on Social Policy), presented with copies of the presentation slides, by Christopher Bender, 25 October, 1997

Memorandum of Understanding between USAID and the Government of Mongolia on Technical Assistance for Pension Reform, November, 1997

Pension Reform Technical Assistance: a Terms of Reference for the period November 1997 to June 1999

International Experience in Pension Reform, by Christopher S. Bender, 18 March 1998

Pension Reform in Mongolia: an Overview, by Christopher Bender, 12 October 1998

A Glossary of Pension Terms, by Christopher Bender, 7 December 1998

APPENDIX B: MEMBERS OF THE EPSP PENSION REFORM EFFORT

Below is a list of the members of the EPSP Pension Reform Effort and a description of the role each member played. "Dates" refers to the period when a team member was actively involved in the EPSP Pension Reform Effort; "LOE" stands for *level of effort* and refers to the number of months (or days) a team member worked for the EPSP Pension Reform Effort; "products" refers to any reports, presentations, or other materials which are particularly noteworthy; and "e-mail" refers to an e-mail address at which a team member can be reached after the EPSP Pension Reform Effort has ended.

NAME	AREA OF EXPERTISE	DATES	E-MAIL
Christopher Bender	Pension Economics	6/97 – 9/00	benderc@aol.com
Greg McTaggart	Pension Administration	11/97 – 9/00	gregmct@aol.com
Jon Tomar	Computer Technology	1/98 – 6/00	tomar@vni.net
Viktoria Olskaia	Public Education	5/98 – 5/00	olskaia@aol.com
Willem Schuddeboom	Actuarial Modeling	12/97 – 6/98	wschuddeboom@inaco.nl
Chris Murray	Tax Collection	11/99 – 11/99	chrism@spin.net.au
Ed Palmer	Labor Economics	3/98 – 7/99	edward.palmer@abc.se
Max Rubin	Windows NT	9/99 – 9/99	max_rubin@hotmail.com
Dejee Zamba	Coordinator	11/97 – 9/00	ssigomon@magicnet.mn
Byambadorj Batbayar	Public Education Coordinator	9/99 – 9/-00	n/a

APPENDIX C: ORGANIZATIONAL DEVELOPMENT PLAN

Earlier in this report, the EPSP Pension Reform Effort recommended that SSIGO restructure the organization with the objectives of (a) giving the Director General and his immediate deputies more time to direct the overall development of the organization, rather than running its day-to-day operations; (b) increasing the utilization of Ulaanbaatar staff by consolidating some of the Ulaanbaatar district offices; and (c) increasing the efficiency of regional staff by organizing offices outside of Ulaanbaatar based on operational demands, rather than mimicking the local governance structure. In developing its five-year plan, the EPSP Pension Reform Effort recommends that SSIGO consider the following suggestions, some of which will be dependent upon expanding SSIGO's administrative budget:

Restructure the organization with the objectives of (a) giving the Director General and his immediate deputies more time to direct the overall development of the organization, rather than running its day-to-day operations; (b) increasing the utilization of Ulaanbaatar staff by consolidating some of the Ulaanbaatar district offices; and (c) increasing the efficiency of regional staff by organizing offices outside of Ulaanbaatar based on operational demands, rather than mimicking the local governance structure.

Allocate more resources for the Headquarters Office: this office currently lacks the funding and staffing necessary for it to (a) effectively manage and control the organization as well as it should; (b) provide greater support to Aimag and district offices; and (c) analyze and present recommendations on matters of social insurance policy. The office needs additional staff. (The ratio of Headquarters staff to field staff is only about one in thirty-five.) The cost of these staff can be offset to some degree by rationalizing the structure of the organization, as is discussed further below.

Establish a compliance unit within Headquarters responsible for pursuing collections from delinquent employers which Aimag, district, and soum offices have been unsuccessful in collecting. The primary function of the Ulaanbaatar City Social Insurance office appears to be checking the amount and timing of contribution returns by Ulaanbaatar employers; perhaps some of the staff from this office could be folded in Headquarters and given responsibility for the debt collection efforts of the entire organization. The remaining staff could be allocated to one of the Ulaanbaatar district offices.

Create a small policy analysis and operational assessment unit, staffed with persons with skills in computer modeling. (These staff members should be given priority for training activities, including especially any future study tours.) The office should be tasked with the responsibility for (a) developing a strategy for the implementation of the remaining tasks required by the reform; (b) evaluating and making recommendations on other matters of social insurance policy; (c) creating computer models to forecast the cash flows of the various social funds, based on economic, demographic, and labor force trends; (d) designing and managing a Management Information System (described below); and (e) assessing operational procedures with the objective of improving efficiency.

Task the policy analysis and operational assessment unit, described above, with a complete review of SSIGO's operational procedures. The review should consider, among other things;

(a) how the ND-7 forms can be redesigned to reduce the work required of employers (for example, is it necessary for employers to break down contributions into various social funds when this can be done automatically by computers?); (b) how automation can be used to reduce the burden of contribution processing, including, for example, the filing of returns electronically by employers in order to save SSIGO from manually having to enter data; (c) whether office hours should be extended in Aimag and district offices and part-time employees should be hired to increase the utilization of computers by data entry clerks; (d) whether returns and contribution payments for employers with operations in more than one location can be consolidated and be handled by one SSIGO office, rather than several; and (e) whether the information now entered into the social insurance books can be reduced, or the books themselves can be eliminated.

Develop a national database of contribution data and use this database as the foundation for developing a Management Information System. The absence of easily accessible data for use in policy analysis severely impairs the ability of policy makers to direct social insurance policy in Mongolia. The creation of a policy office within SSIGO, when combined with greater data accessibility, will substantially improve the support SSIGO can provide to the GOM on matters of social policy.

Reconsider the operating relationship between SSIGO and the IT Center: the IT Center is, in theory, intended to operate as a self-financing organization, whereby it sells services to organizations other than SSIGO. (In practice, the IT Center has no other significant clients, which has enabled it to give its full attention to the implementation of the pension reform.) It is still too early to determine whether this operating relationship is beneficial to SSIGO. This relationship should be reevaluated in two years.

Reevaluate the organization's salary structure. Salaries within SSIGO are very low, particularly for SSIGO's most senior managers who earn less than junior staff working for private companies. Non-competitive wages result in higher turnover and absenteeism, create incentives for the organization's more capable staff to find other jobs, and hamper efforts to improve service quality. SSIGO should review the base wages paid for different positions within the organization, paying close attention to the wage differentials paid to senior managers. Of particular concern is the current practice of reducing wages for staff who fail to meet contribution collections targets. While the EPSP Pension Reform Effort supports performance-based compensation, it is critical that performance targets be attainable. Given that approximately a third of the debt owed to SSIGO is owed by budgetary organizations and another third is owed by state-owned enterprises, it would be unfair to penalize staff for being unable to collect contributions from these organizations. Moreover, it would be more conducive to morale if performance-based compensation programs were supported not only by penalties for substandard performance but also by bonuses for exceeding performance targets.

Conduct a study tour for senior managers to countries such as Australia, Singapore, and Malaysia to learn how social insurance systems in those countries are administered and to learn about the challenges of administering non-state pension funds. (This activity will obviously be dependent upon support from the donor community.)

Introduce an employee performance evaluation program to (a) clarify the roles and responsibilities for the organization's staff; (b) set annual performance goals; (c) annually evaluate the progress made toward those goals; and (d) improve performance within the organization. The performance evaluation program should be tied to compensation arrangements.

Develop skills tests for recruiting purposes to better clarify job requirements and identify qualified applicants.

Create three new positions of Deputy-Director General within the Headquarters office. One Deputy-Director General should be given overall responsibility for managing the operations of the Ulaanbaatar offices. A second should be given responsibility for offices outside of Ulaanbaatar. The third should be given responsibility for Headquarters services, including accounting, information technology, training, and so forth. This Deputy-Director General should also fulfill a line function (for example, he or she might also be responsible for the accounting department, as well as overseeing the work of other line managers).

In Ulaanbaatar, the number of District offices should be reduced to four or five, with the Tuv Aimag office falling under the control of the Deputy-Director General for Ulaanbaatar offices.

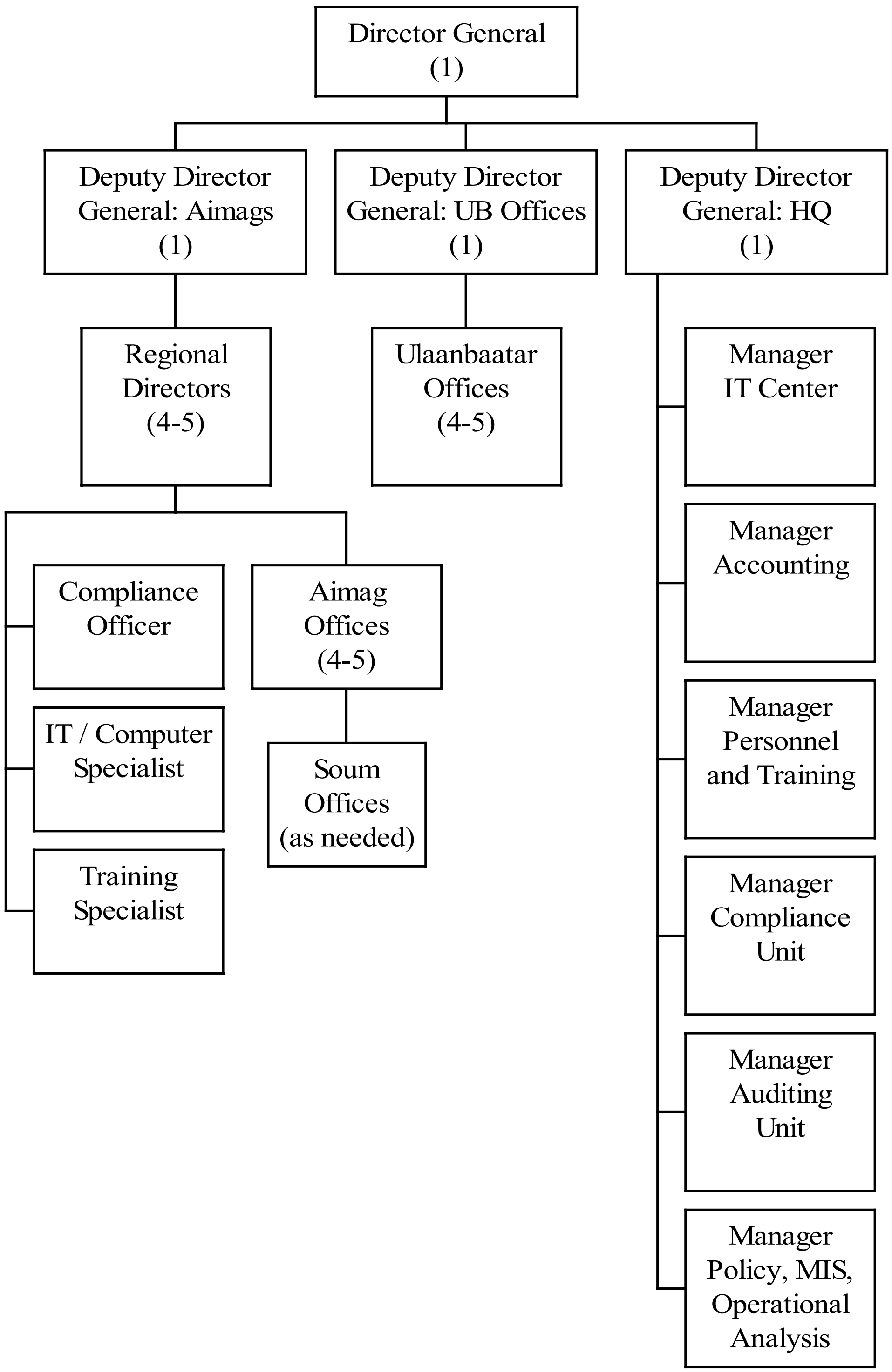
The Ulaanbaatar City office should be disbanded, with some of the staff assigned to a newly created National Compliance unit, as suggested earlier, and the rest of the staff allocated to Ulaanbaatar district offices.

Outside of Ulaanbaatar, SSIGO should arrange its offices according to geographic proximity, rather than mimicking the local governance structure. In other words, local offices should be located where they are needed and should report to the *closest* Aimag or regional office, regardless of whether the closest Aimag or regional office is located in the Aimag center that has political jurisdiction over the local area in question. (For example, SSIGO's local office in Baruun Kharaa soum reports to the Sukhbaatar Aimag center, which is 200 kilometers distant, rather than the Darkhaan-Uul Aimag center, which is only 40 kilometers away. Reassigning it to the Darkhaan-Uul Aimag center makes practical sense and will save money.)

Consider establishing regional offices to support four or five Aimag offices and assigning a small core of specialists to each regional office. Such specialists could cover such areas as computers and informational technology (this will become particularly important when computers are fielded to more and more soums), training, contribution payment compliance, and so forth.

Presented below is an organizational chart which reflects these recommendations:

Proposed Organizational Structure for SSIGO



APPENDIX D: IMPROVING CONTRIBUTION COLLECTIONS

REGISTRATION OF EMPLOYERS AND EMPLOYED PERSONS

1. All enterprises registered with the business registration unit in the State Tax Authority should be automatically registered with SSIGO as employers.

2. The State Tax Authority should send an updated registration database to SSIGO computer center on a weekly basis.

3. SSIGO's registration database should be amended to include a field for the Taxpayer Registration Number, and eventually this number should replace the Certificate Number as the primary identifier.

4. SSIGO should record in their database the business activity (ISIC) codes and other data provided by employers at the time of registration with the State Tax Authority

5. Self employed individuals who make voluntary contributions should use their Citizens Register Number as the primary identifier.

6. Self employed individuals who have employees should be registered both with the State Tax Authority and with SSIGO as employers and should be required to withhold personal income tax and pay social insurance contributions on their employees' wages, just like other employers.

THE PROCESSING OF CONTRIBUTION FORMS AND PAYMENTS

1. The employer declaration forms (ND-7 forms) and the contributor declaration forms (ND-8 forms) are out of date and should be redesigned to simplify their completion and to eliminate the requirement for employers to split the contributions between different funds.

2. When SSIGO establishes an Internet web site, employers should be able to download these forms for free from the web site.

3. SSIGO should encourage employers with more than 100 employees to file contribution declaration forms by diskette using a standard spreadsheet format.

4. SSIGO should request employers to put their Certificate Number and Taxpayer Registration Number on all bank payment forms so that payments can be easily recorded against the correct accounts.

5. The information in the salary books of current contributions now duplicates the information already recorded in SSIGO's computer system. Within the next 12 months, after the first annual contribution statements have been sent to all contributors, it should

be possible to phase out the salary books, thereby eliminating a major workload for both employers and SSIGO.

PRIMARY CONTROL SYSTEMS

1. The system identifies missing monthly declarations, but a non-filer action report should be produced to list all employers with missing declarations, ranked in order of the number of outstanding declaration forms. This report should be produced in the middle of each month – about 14 days after the declarations are due to be filed.

2. Bank deposits to pension fund accounts are reconciled with payments credited to employers' SSIGO accounts, but usually the same person who inputs the payments also does the bank reconciliation. *This is an internal control weakness*, and the reconciliation process should be regularly checked by SSIGO office manager or by internal auditors from SSIGO Headquarters.

DEBT COLLECTION

1. Debt collection units should be established to deal with debts older than one month.

2. Initial collection action should be taken by telephone and written demands.

3. SSIGO needs the same legal powers as tax inspectors (see the Law on Supervision of Tax Levy, Payment and Tax Collection).

4. SSIGO should coordinate and meet with the State Tax Authority before taking Court action.

5. The Social Insurance Fund should receive preference over other tax debts for the payment of debts by debtors.

AUDIT ACTIVITIES

1. Employers should be audited by specialist inspectors. Audit work requires specialist staff. This should not be done in conjunction with other work.

2. Improved selection criteria should be used for choosing audit cases.

3. Auditors need access to external information – particularly information from the State Tax Authority – in order to identify risks and select cases with high revenue potential.

4. Different types of audits should be used to increase efficiency.

5. Auditing activities should follow an annual plan, which specifies auditing targets (expressed in terms of case numbers).

6. Auditing performance should be measured against the targets established in the annual plan.

7. The audit plan should be reviewed annually to see if it was achieved.

8. SSIGO should compare the amount of audit revenue and penalties collected in the current year versus the previous year, by office.

9. SSIGO should compare the audit revenue calculated with the audit revenue actually collected.

10. SSIGO should evaluate the number of cases per auditor and the quality of work done.

COOPERATION WITH THE STATE TAX AUTHORITY

1. The State Tax Authority can provide SSIGO with regular updates of the business taxpayer registration database.

2. Monthly meetings should be held between the State Tax Authority and SSIGO managers in each district and Aimag to (a) discuss debt collection issues; (b) exchange of information about the largest debtors; and (c) help identify and locate missing employers.

3. SSIGO should produce annual employer certificates that summarize the wages reported by a given employer for social insurance purposes. These certificates should then be filed by employers when they file their returns with the State Tax Authority. This will enable the State Tax Authority to (a) identify cases where employers are under-reporting wages for social insurance purposes or over-reporting wages for tax purposes; and (b) take appropriate action, including the assessment of penalties for fraudulent reporting. (This same objective might also be accomplished if employers are required to attach their ND-7 forms when they file their returns with the State Tax Authority, provided that this requirement is strictly enforced. The use of an annual employer certificates, however, might be easier.)

4. The State Tax Authority should audit social insurance contributions when conducting audits, and advise SSIGO of the results.

5. It would be appropriate for SSIGO and the State Tax Authority to prepare a cooperation agreement to incorporate the above issues. It may also be necessary to make changes in the laws to allow the two organizations to exchange information.